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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

International Finance Series

Foreign Reaction to the Currency Settlement and the Outlook for International Monetary Stability

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February 1973

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
February 1973

INTELLIGENCE MEMORANDUM

FOREIGN REACTION TO THE CURRENCY SETTLEMENT AND THE OUTLOOK FOR INTERNATIONAL MONETARY STABILITY

SUMMARY

1. The international monetary crisis ended at least temporarily with the 12 February currency settlement. The dollar initially strengthened in Europe but then weakened somewhat in light trading. The Deutschemark closed near its ceiling against the dollar on 26 February, but for much of the post-settlement period it was at or near its new floor. Indeed, the Bundesbank has had to sell about US $1 billion since reopening its foreign exchange markets to keep the mark above its floor. In Japan, the yen has appreciated about 16% relative to its old central dollar rate.

2. Foreign reaction to the dollar devaluation has been generally favorable, although there is increasing concern about the settlement's durability. West Germany is relieved that it did not have to act unilaterally or revalue relative to most of its major trade partners. Bonn and Paris are gratified by the new cooperative spirit they demonstrated in response to the recent crisis. The United Kingdom and Canada are pleased because they were not forced to stop floating and have now gained a competitive advantage relative to most of their trade partners. The less developed countries (LDCs) see the US devaluation as reducing the likelihood of protectionist measures which would have been harmful to them.

3. Most nations anticipate little short-term damage to their foreign trade or domestic economies because of the settlement. Japanese industrialists, except those in light manufacturing industries, are generally

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence. It covers information through 26 February 1973. Questions and comments are welcome. They may be directed to [redacted] 25X1 confident they can meet competition in foreign markets. In any event, continued large 1973 trade surpluses for Japan and West Germany appear inevitable.

4. Nevertheless, much of the negative comment about the dollar devaluation and the yen appreciation has emanated from Japan. Tanaka was forced to apologize to the Diet for floating the yen, as businessmen and politicians were outraged by the magnitude of the exchange rate change. Tokyo is also concerned about future US trade and monetary measures directed against Japan. The French press too has been critical, focusing on the size of the US devaluation, expectations of a new wave of American takeovers of European firms, and, again, fears of new US trade demands.

5. Many of the potential destabilizing factors that produced the recent crisis are still present. International institutions hold hundreds of billions of dollars in liquid assets, some of which they are prepared to move rapidly among currencies and foreign exchange markets for profit or protection. Speculative flows have increased in volume and velocity, with capital controls, which vary significantly among nations, proving to be only a minor obstacle. The next upheaval could be triggered by either an unexpected worsening of the trade balance or by domestic economic or political problems in an industrial nation. At this point in time, a joint float of European currencies appears to be a likely response to another international crisis.

DISCUSSION

Renewed Currency Turmoil[1]

6. The Smithsonian Agreement in December 1971, which resulted in an extensive realignment of world currencies, was expected to improve the US trade balance, reverse the large dollar outflows, and reduce speculation in currency markets. Within six months, however, the first crack appeared in the new exchange rate structure as it became apparent that sterling was overvalued. London was forced to float the pound on 23 June 1972, and a run on the dollar ensued. Large-scale dollar support by European and Japanese central banks and new and strengthened capital controls were required to calm the situation. As the year wore on, it became increasingly clear that further currency changes might be needed; the US trade balance continued to worsen and Japan and West Germany showed record trade surpluses.

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7. The present currency crisis was triggered by Italy's decision on 22 January 1973 to institute a two-tier exchange rate system similar to those in Belgium and France, to reduce Italy's continuing capital outflow and protect the lira from growing speculation. Although motivated by uniquely Italian factors, Rome's decision had repercussions throughout world financial markets, particularly in Switzerland and then West Germany.

8. Switzerland, the principal recipient of much of Italy's legal and illegal capital outflows, floated its franc on 23 January. The new Italian controls increased the demand for Swiss francs as did French purchases of gold coin in the Zurich market, which were stimulated by growing French political uncertainties. The Swiss National Bank was forced to purchase about $200 million in foreign exchange to keep the franc within the Smithsonian bands. Bern's decision to float "temporarily" after such relatively small purchases was motivated by its unwillingness to accumulate additional currency reserves, as an earlier reserve buildup had been partly blamed for Swiss inflation.

9. Although money managers were unsure that the Swiss action was warranted, Bern's decision generated speculative pressures in other currency markets. Speculators evidently believed that the Bundesbank would be forced to float the mark, particularly since Germany was also suffering from inflation. Although relatively small but psychologically significant US sales of marks and guilders through 1 February temporarily helped restore confidence in the dollar, European central bank intervention in the market already had become quite substantial (see Table 1). After the close of trading on 2 February, the West German cabinet, in an extraordinary session, strengthened Germany's capital controls in an effort to reduce speculative capital inflows.

10. During the week of 5-9 February the crisis became a test of strength between the Bundesbank and speculators – initially commercial banks and then multinational corporations – as traders concluded that the new currency controls would not be adequate. Dollar intervention by the Bundesbank during 6-9 February amounted to about $5 billion. This brought total German dollar intervention since 1 February to almost $6 billion, more than was required in any previous crisis. In Tokyo, despite tight capital controls, central bank intervention reached about $1 billion.

11. On Friday, 9 February, the dollar was still at its floor relative to most major currencies, despite total cumulative foreign intervention of more than $8 billion. The situation had reached crisis proportions. Rumors of a US devaluation, a joint European float, and a yen revaluation spread as various high-level meetings were held to discuss the crisis. Concerned about further speculative capital inflows, Tokyo closed its currency market

Table 1

Foreign Central Bank Dollar Intervention
23 January - 9 February 1973

Million US $

	23-31 Jan	1 Feb	2 Feb	3 Feb[a]	5 Feb	6 Feb	7 Feb	8 Feb	9 Feb	Total
Total	264	533	1,187	275	32	1,694	271	1,922	2,071	8,249
Belgium	2	70	118	--	--	10	--	3	45	248
Canada	--	--	--	--	--	--	--	--	--	..
France	10	--	--	--	--	--	--	--	--	10
Italy	..	--	--	--	--	--	--	--	--	--
Japan	--	71	173	275	17	--	245	104	215	1,100
Netherlands	2	3	62	--	--	54	3	95	168	387
Switzerland	--	--	--	--	--	--	--	--	--	..
United Kingdom	35	100	--	--	15	55	5	--	--	210
West Germany	--	239	824	--	--	1,505	18	1,695	1,633	5,914
Other[b]	215	50	10	--	--	70	--	25	10	380

a. Only the Japanese exchange is open on Saturday.
b. Including the Scandinavian countries.

on 10 February – the only major market open on Saturday. Major European countries announced they would not open their foreign exchange markets on 12 February.

Currency Settlement

12. US Treasury Secretary Shultz announced on the evening of 12 February that the United States would devalue the dollar 10.0% relative to gold. This action raises the official gold price (subject to congressional approval) from $38 per troy ounce to $42.22 per troy ounce. As an integral part of the currency settlement, France and West Germany agreed to maintain their existing gold parities, thus revaluing their currencies 11.1% in terms of the dollar's new central rate (see Table 2). Tokyo agreed to float the yen. Canada, Switzerland, and the United Kingdom continued their floats, and Italy extended its float to the commercial lira. Other countries altered their parities to varying degrees.

Recent Market Developments[2]

13. Most money markets reopened on 14 February (the London exchange reopened on the 13th). Initial trading was cautious, but the dollar subsequently gained strength. Indeed, the West German Bundesbank was required to sell about $1 billion during 19-21 February to keep the mark above its floor against the dollar. These were the first such sales since

2. As of 26 February.

Table 2

Reported Status of World Currencies[a]

Floating		
Bangladesh	Ireland	Nepal
Canada	Italy - both tiers	Switzerland
Guyana	Japan	United Kingdom
India	Malawi	
Maintaining gold parity[b]		
Abu Dhabi	Hong Kong	Pakistan
Australia	Hungary	Peru
Austria	Iran	Poland
Bahrain	Iraq	Qatar
Belgium	Jordan	Rhodesia
Bulgaria	Kuwait	Romania
Czechoslovakia	Lebanon	Saudi Arabia
Denmark	Malagasy Republic	Singapore
Dubai	Malaysia	South Africa
East Germany	Morocco	Spain
Ethiopia	Netherlands	West Germany
France	New Zealand	Zambia
Ghana	Norway	
Individual revaluations against the dollar[c]		
Brazil - 3%	Portugal - 6.86%	USSR - 9.4%
Finland - 5.55%	Sweden - 5.55%	Venezuela - 2.3%
People's Republic of China - 7.5%	Taiwan - 5%	
Devaluing with the dollar		
Argentina	Indonesia	South Korea
Bahamas	Israel	South Vietnam
Bolivia	Jamaica	Sudan
Colombia	Kenya	Surinam
Costa Rica	Liberia	Tanzania
Dominican Republic	Mexico	Thailand
El Salvador	Netherlands Antilles	Turkey
Greece	Nicaragua	Uganda
Guatemala	Nigeria	Yugoslavia
Honduras	Paraguay	Zaire
Iceland	Somalia	
Individual devaluation against the dollar[c]		
Uruguay - 2.8%		

a. As of 26 February.
b. Revaluing 11.1% in terms of the dollar's new central rate.
c. Relative to the dollar's new central rate.

summer and the first needed to maintain the Deutschemark floor since 1969. The mark's weakening relative to the dollar reflected some unwinding of massive speculator positions in a thin market. The cost of maintaining a mark position rose because of the increase in Eurodollar interest rates and the recent imposition of a roughly 10.0% annual negative interest charge on post - 31 January non-resident deposits in German commercial banks. The charge is made, in part, to cover any losses arising from higher German minimum reserve requirements.

14. On 22 and 23 February the dollar unexpectedly weakened somewhat in light but chaotic trading in Europe, before stabilizing on 26 February. Small central bank intervention reportedly was required on 23 February in West Germany, France, Belgium, Switzerland, the Netherlands, and Sweden to keep the dollar above its new floor. Total intervention probably amounted to less than $100 million. The revaluation of most European currencies relative to their predevaluation dollar market rates is consequently now almost 10% (see Table 3). This early weakening contrasts with the experience following the Smithsonian Agreement. Then the dollar also showed early strength but did not fall to its floor against the strong European currencies for several months (see the chart).

Table 3

Major Currency Revaluations Against the Dollar from Predevaluation Market Rates[a]
14-26 February 1973

Percent

	14 Feb	*15 Feb*	*16 Feb*	*19 Feb*	*20 Feb*	*21 Feb*	*22 Feb*	*23 Feb*	*26 Feb*
Belgian franc	7.0	7.2	7.4	7.5	7.2	7.4	8.0	9.9	7.2
Canadian dollar	1.2	0.8	0.8	0.8	0.8	0.8	0.9	0.9	0.5
French franc (commercial)	7.8	7.7	7.6	7.5	7.2	7.5	7.8	10.4	9.2
Italian lira (commercial)	2.3	1.5	2.0	1.6	1.3	1.0	2.0	2.4	2.2
Japanese yen	11.2	13.4	13.4	13.8	13.4	13.9	13.6	13.4	14.0
Netherlands guilder	6.6	6.9	6.7	6.7	6.7	6.9	8.3	10.6	10.1
Swiss franc	4.7	6.1	5.8	5.8	6.0	6.5	9.1	9.7	9.5
UK pound	3.5	3.1	1.9	1.7	2.2	2.4	3.2	3.7	3.4
West German mark	6.8	6.5	6.3	6.1	6.1	6.1	7.7	9.3	9.4

a. In terms of central rates the non-floating currencies have revalued 11.1% relative to the dollar.

15. The major floating currencies present a mixed picture. The Swiss franc has shown continuing strength, and has appreciated about 10% from its predevaluation dollar market rate and almost 20% from its old central dollar rate. The pound and commercial lira have appreciated only slightly – about 3.4% and 2.2%, respectively – from their predevaluation dollar market rates. The Canadian dollar has tended to float with the US dollar and shows only a marginal appreciation.

16. Initial trading in Tokyo was accompanied by heavy Bank of Japan intervention. More than $300 million was purchased in the first two days of trading to slow the yen's appreciation. Since then, intervention has been slight and the yen appears to have stabilized – at least temporarily – at about 16% above its old central dollar rate. Pressures for further appreciation may soon build, however, as large export contracts that were delayed earlier in the month begin to come due.

17. Throughout the crisis, demand for gold has been strong, reflecting continuing uncertainty about the future of the international monetary system. Some speculative funds moving out of marks were thought to be moving into gold. The price of gold reached a record high of $95 on 23 February in a thin market. It immediately weakened, however, and closed at about $80 on 26 February. Demand has been strong worldwide. Traditional Middle East hoarders, who dropped out of the picture during the 1972 upsurge, have reentered the market. Industrial users have also sought to replenish their already depleted stocks in anticipation of further price rises.

European and Canadian Reaction

18. Initial West European and Canadian reaction to the currency settlement was generally favorable, but increasing concern is now evident over the long-term implications for international trade and monetary stability. The quick US decision to devalue the dollar spared Europeans, particularly EC members, another real test of their ability to cooperate.

European Community

19. The EC finance ministers at a regularly scheduled meeting on 14 February approved the new currency settlement and hailed the US action as a major contribution to international monetary stability. Tensions have emerged within the community, however, because of the failure of the EC big four (France, West Germany, Italy, and the United Kingdom) to consult with the smaller states about the terms of the settlement. Italy's decision to float the commercial lira, altho h not entirely unexpected, has also injected a sour note. Nevertheless, the finance ministers at the

14 February meeting reaffirmed the basic EC objective of complete economic and monetary union.

20. The US decision to devalue the dollar was preceded by community discussions about a possible joint EC solution to the crisis. There was remarkable agreement between the French and Germans, although for different reasons; both strongly opposed a unilateral Deutschemark revaluation or float. The Germans proved more willing than before to consider a dual exchange market system, and the French were less opposed to a common float of EC currencies vis-a-vis the dollar. French-German agreement was ultimately reached on a common EC float, but this was opposed by the United Kingdom which did not want to repeg the pound relative to other EC currencies. The French-German position -- in sharp contrast to their policy differences, which prolonged the 1971 monetary crisis -- assured quick community approval of the "US solution."

21. Community concern over the long-run implications of the crisis and the currency settlement is growing. The announced US intention to submit trade legislation to Congress will remove an excuse for foot-dragging on the part of the community and force a decision on trade policy. It is also generally recognized that the basic speculative pressures which generated the current crisis are still present and that international monetary reform should consequently now have first priority. West German Finance Minister Schmidt indicated that a joint float of EC currencies against the dollar has been agreed to in principal if the currency crisis repeats itself. Preparations apparently are under way to work out the modalities of a joint EC float. UK spokesmen point out, however, that technical problems have still to be resolved before a joint float can be implemented. Because three EC currencies are floating, different exchange market systems are in use in the community (four members, Belgium, Luxembourg, France, and Italy, now have dual exchange rate systems), and the relative strength of EC currencies differs, a joint float would be difficult to implement.

France

22. Official French reaction has been favorable but there has been sour comment in the press over possible US trade demands and a new wave of American takeovers of European enterprises when US controls on capital outflows are removed. There has also been some criticism that the US devaluation was excessive and represented an attempt by the United States to gain a larger share of world markets. Finance Minister Giscard d'Estaing welcomed the devaluation, noting that this was the solution favored by France. [redacted] 25X1

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23. French officials expect the currency settlement to have little impact on France's trade account (see Table 4). Only a very small proportion of France's trade – about 6.5% in 1972 – was with the United States. Nevertheless, in certain industries, including steel and aircraft, the impact may be substantial. There is also some concern that the dollar's devaluation combined with an unchanged mark parity could lead to an outflow of short-term funds from France, particularly if uncertainty over the outcome of the March general elections increases.

Table 4

Comparative International Accounts
1972

Million US $

	Trade Balance (f.o.b./f.o.b.)	*Current Account Balance*[a]	*Basic Balance*	*International Reserves*[b]
Belgium-Luxembourg	1,200	1,300	1,200	3,870
Canada	1,300	-600	700	6,050
France	1,300	1,100	200	10,015
Italy	700	2,800	2,100	6,079
Japan	9,000	7,100	2,200	18,365
Netherlands	1,800	2,500	2,200	4,785
Switzerland	-1,200	70	N.A.	7,488
United Kingdom	-1,800	400	-1,700	5,647
United States	-6,800	-6,000	-10,000	13,150
West Germany	8,300	700	4,400	23,427

a. Excluding government grants.
b. As of 31 December 1972. Because of the currency crisis, most countries' reserve holdings are now substantially larger. West Germany's international reserves, for example, now total about $30 billion.

West Germany

24. West Germans are pleased that Bonn did not have to act unilaterally or revalue relative to most of its trade partners in order to stem speculation against the mark. Bonn's attitude has improved remarkably over two weeks ago, when Washington was being accused in German inner circles of fermenting the monetary crisis in order to force a mark float. Chancellor Brandt expressed pleasure that there had been no damage in

US-West German relations because of the crisis while Finance Minister Schmidt praised the spirit of cooperation he found in his dealings, singling out France and the United States for special thanks. Reflecting, in part, West German gratitude for the US role in restoring monetary calm, Schmidt also supported the US stand that trade and monetary negotiations must be tied and indicated that Bonn would seek to play an active and positive role in the multilateral trade talks. Opposition leader Barzel also saw the US decision as an important contribution to ending the present crisis.

25. West German officials expect the currency settlement to have a relatively small impact on the economy and the balance of payments. Indeed, in view of the accelerating business upturn and rising inflationary pressures, a moderation of export demand would exert a welcome stabilizing influence. Karl-Otto Poehl, State Secretary in West Germany's Finance Ministry, estimates that the dollar devaluation and yen float will have a combined effect equivalent to roughly a 2% appreciation of the mark. With the exception of the coal industry, now worried about increased competition from cheaper US coal, the impact will fall primarily on manufacturing. The automotive, iron and steel, machine building, electrical and electronic equipment, and shipbuilding industries will be most directly affected. The simultaneous float of the Japanese yen, however, will help German exports to the United States and other markets where Japan is their principal competitor.

Italy

26. Most Italians have reacted favorably to the currency settlement and to Rome's decision to continue its dual float. Although the float's short-term impact will be unfavorable, owing to the adverse terms of trade effect, in the long run it will tend to increase Italy's already impressive trade surplus. While the Treasury Minister indicated that the central bank would intervene to control the float, too dirty a float could precipitate a French reaction to the new exchange rate advantage given the Italians. Even if the lira strengthens somewhat over the next few weeks, it still will be considerably devalued relative to other EC currencies. The competitiveness of Italian goods in EC markets – which account for about a half of Italy's exports – will consequently be enhanced. On balance, however, the lira will probably remain relatively weak as underlying domestic political and economic uncertainties persist.

United Kingdom

27. British officials and the public have generally praised the currency settlement and the US role. Chancellor of the Exchequer Barber welcomed the new currency arrangements and the remarkable speed with which a solution was obtained. He was joined by Prime Minister Heath, who

indicated that the first priority must now be international monetary reform. Government officials expect the settlement and the pound's slight devaluation relative to the currencies of the United Kingdom's trade partners to benefit the economy. In the short run, however, it could worsen Britain's balance of payments; US brokerage houses in London have reported very heavy orders for US securities, a situation that may increase net outflows of long-term capital.

Canada

28. Canadian reaction, although generally low-key, has been relatively favorable. Ottawa's decision to continue floating will not have much effect on the US-Canadian dollar exchange rate which, for psychological reasons and because of Canadian intervention, has stabilized at approximate US-Canadian dollar parity. The settlement is consequently expected to have relatively little impact on Canadian trade, about 70% of which is with the United States, although it may dampen somewhat the growth of imports from Japan, especially of automobiles. The Canadian press and spokesmen of the government and opposition, although pleased that no action was taken to restrict trade, are apprehensive about possible future US trade measures. Particular attention was directed at President Nixon's promise of tough trade legislation.

Japanese Reaction

29. Japanese reaction has been overwhelmingly negative. The realignment and float, although not unexpected, have dismayed and confused government and business leaders. Even before the February crisis, many Japanese, including Prime Minister Tanaka, realized that a second yen revaluation was inevitable, but most anticipated an appreciation of 10% or less. The government is being sharply criticized for the float and was forced to apologize to the Diet for the decision. Tokyo is also concerned that the United States might raise tariffs on Japanese goods and press for concessions to reduce Japan's trade surplus. The government and press describe the recent talks with Special Trade Representative Eberle as the start of "operation trade and currency" against Japan.

30. Japan's immediate problem is when and where to end the yen float. If the float continues without intervention, the yen will almost certainly appreciate further. Tokyo is anxious, however, to avoid international criticism of a dirty float. Moreover, recent experience has demonstrated that heavy central bank intervention tends to intensify speculative pressure on the yen. Tokyo could quickly repeg the yen, but the new central rate would have to be well above the present floating rate if international money managers are to be satisfied that the revaluation sufficiently reflects market conditions.

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32. Criticism by spokesmen for the major industries has not been especially sharp, inasmuch as the economic issues raised by the currency realignment are not particularly worrisome. Major industries such as automobiles, steel, and shipbuilding are confident that by and large they can meet competition in foreign markets. Moreover, with sales in the domestic market rising rapidly, many firms are in a better position now than in 1971 to absorb some slowdown in overseas sales. Some Japanese firms, however, will be hurt by revaluation. The most seriously affected will be the politically sensitive labor-intensive industries such as textiles which face increasing competition from nearby East Asian suppliers. Tokyo is considering providing these industries financial assistance aimed at upgrading and modernizing their operations.

Reaction of the Less Developed Countries

Oil Producers

33. Oil producer reaction has generally been low key, in part because oil prices will increase as a result of the dollar's devaluation. The Persian Gulf countries, Libya, and Nigeria have agreements with Western oil companies for automatic quarterly adjustments in tax reference prices based on a foreign exchange parity index of nine major currencies relative to the US dollar. The next computation date is 1 March, and the adjustments will probably take place on 1 April. According to the agreed formula, an average increase of 10%, for example, in the value of the nine currencies relative to the dollar would mean about an 8% increase in government revenues and, assuming that profits per barrel and production costs remain constant, a 6% increase in the dollar price (f.o.b.) of crude oil. Venezuela, Indonesia, and Algeria will also attempt to achieve matching compensatory increases.

34. The increased dollar cost of crude oil will probably have little effect on retail oil prices in Japan and Europe, however, because, at the new exchange rates, there will be no increase in oil import costs in terms

of domestic currency. Oil import costs for the United States will increase, but the US domestic crude oil price will continue to exceed the price of foreign oil, and hence US retail oil prices should remain unchanged. Retail prices in many less developed countries undoubtedly will rise, but the percentage increase will be less than the increase in revenues for the oil countries because revenues comprise only a small part of the retail price of petroleum products.

Other

35. Most LDCs strongly support the dollar's devaluation because, in their view, this has made US adoption of protectionist measures less probable. As self-proclaimed leaders of the Third World, Latin spokesmen had been waging a campaign against a US response that would damage LDC interests, even though aimed at "the world powers responsible for the US balance-of-payments crisis." They have strongly opposed an overall import surcharge and other controls adversely affecting their market access. Apprehensions on this score have lessened visibly, although they still see the protectionist mood in the US Congress as a cause for concern. Some Latin American nations, especially Mexico and Argentina, have also stressed the need for increased controls over multinational firms, singling them out as major culprits in the recent monetary crisis.

36. Official and press comment in the Third World reflects sharply reduced confidence in the dollar. The dollar is openly contrasted with such "hard currencies" as the mark and the yen. Predevaluation reserve shifts out of dollars were limited largely to Middle Eastern oil producers, but several of the more important LDCs in Latin America and elsewhere now view their present dollar holdings as excessive. There is no evidence, however, that Brazil, Venezuela, or Mexico – holding total reserves of $4.1 billion, $1.6 billion, and $1.3 billion, respectively – plan at this time to shift any dollar holdings to other currencies.

37. Because most LDCs are devaluing along with the dollar, their officials expect the ongoing currency realignment to benefit their exports. In dollar terms, prices of primary commodities – the mainstay of most LDCs' export earnings – already have risen and are expected to remain above their predevaluation levels even after speculative activity subsides. LDC exporters of manufactures should be helped because of their improved competitive position relative to Japan and Western Europe. The major beneficiaries will be those LDCs with relatively large manufacturing sectors such as Taiwan, Hong Kong, and South Korea in the Far East and Brazil, Mexico, and Argentina in Latin America. Brazil, for example, attributes its 40% jump in export earnings in 1972, in part, to the Smithsonian realignment's impact on manufacturing sales. Some of the LDCs will also

benefit from the increased tendency on the part of European and Japanese manufacturers to shift facilities to third countries. Sony's plan to establish a large plant in Brazil is well along, and Volkswagen is now more likely to follow through on its reported plan to transfer some export production to Mexico and Brazil.

38. The devaluation also has had a favorable impact on the foreign debt burden of most LDCs, since the bulk of these debts are denominated in dollars. The devaluation will tend to increase domestic inflationary pressures, however, particularly in countries which rely on Japan and Western Europe for most of their imports.

Prospects for International Monetary Stability

39. The most recent crisis clearly demonstrates the ease with which enormous quantities of money can be shifted in short periods of time among major currencies and exchange markets. The roughly $8 billion that foreign central banks purchased during 1-9 February was a larger, faster flow than in previous crises. In the three weeks following the sterling float last June, for example, movement out of dollars into European currencies and yen was $6 billion. Germany's support of the dollar this February was larger than in any earlier crisis, although before floating the mark in early March 1971 the Bundesbank was forced to purchase $1 billion in 40 minutes of trading.

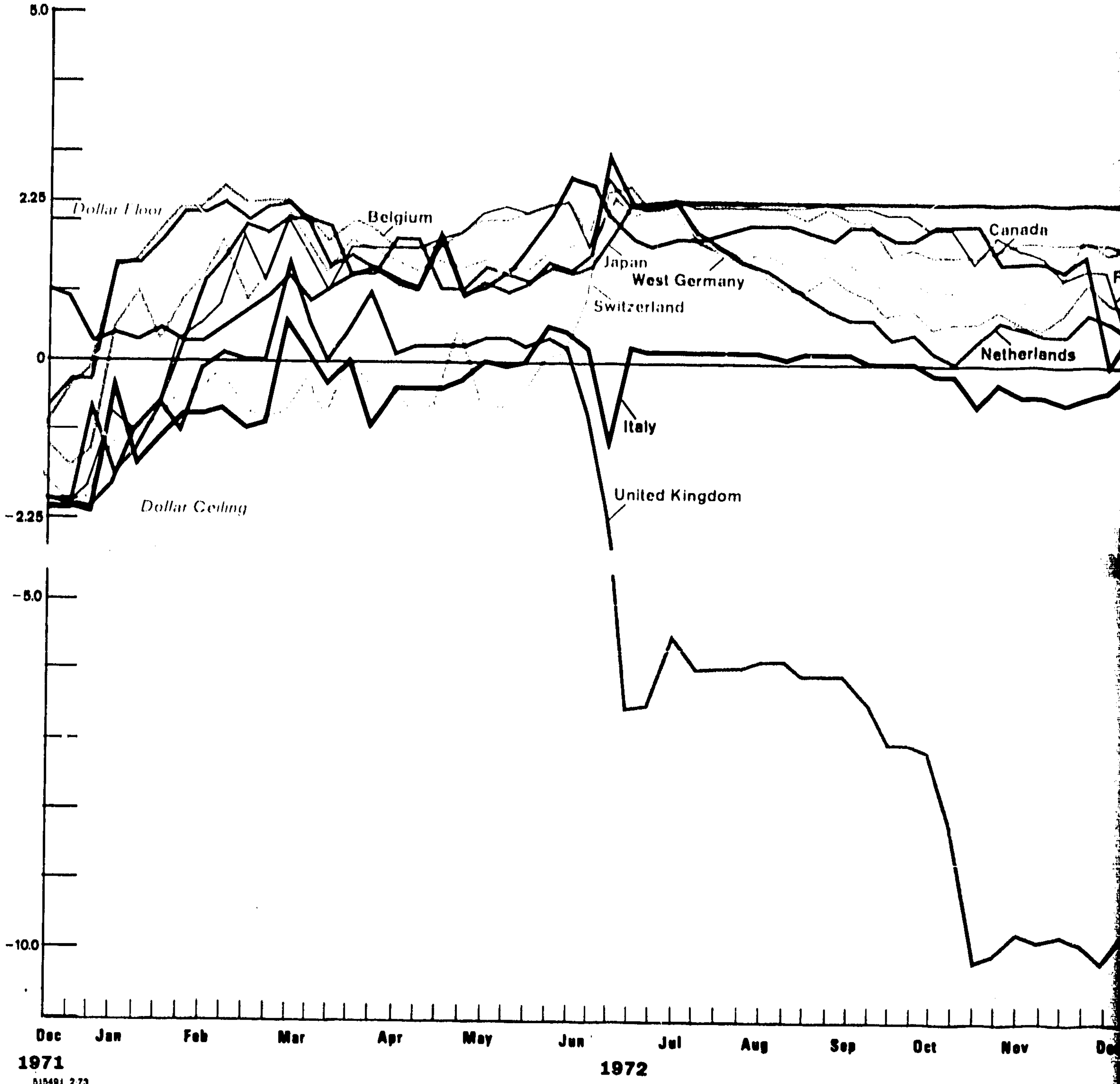
40. Banks and multinational firms will continue to be a potential destabilizing factor in the international monetary situation. They hold perhaps $300 billion in liquid assets, much of which can be moved in anticipation of exchange rate changes. These institutions also take advantage of superior communications, management, and computer facilities to speed their decisions and monetary movements.

41. While capital controls impede international flows, they are far from insurmountable obstacles. Tightened controls in one country encourage flows to other countries with looser or no controls. Controls often represent an added cost to the speculator but one which he anticipates will be more than covered by gains from the change in exchange rates.

42. The next crisis could be triggered by any one of a number of factors. Any weakness – real or perceived – in the balance of payments of an industrial nation often creates ripples throughout world currency markets. Moreover, the country does not have to be a major financial power. Italy's domestic problems and a Swiss overreaction triggered the speculative attack on the dollar in early February. The hectic trading on both the gold and currency markets in late February clearly demonstrates the doubts that traders have about prospects for monetary stability.

POST-SMITHSONIAN EXCHANGE RATES

(Percent)



POST-SMITHSONIAN EXCHANGE RATES

(Percent)